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No. 98-1058

In the Supreme Court of the United States

OCTOBER TERM, 1998

ROBERT D. POTTS, PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION

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QUESTION PRESENTED

Whether substantial evidence supports the finding of the Securities and Exchange Commission that petitioner, a certified public accountant, failed to comply with applicable professional accounting and auditing standards while he was acting as the concurring partner in an audit.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A-1 to A-7) is reported at 151 F.3d 810. The opinion and order of the Securities and Exchange Commission (Pet. App. A-9 to A-61) are reported at 7 Fed. Sec. L. Rep. (CCH) ¶ 74,479.

JURISDICTION

The judgment of the court of appeals was entered on August 4, 1998. A petition for rehearing was denied on September 30, 1998 (Pet. App. A-8). The petition for a writ of certiorari was filed on December 28, 1998. The

jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner, a certified public accountant, was a partner at Touche Ross & Co. and its successor firm Deloitte & Touche (Touche). Pet. App. A-2. While at Touche he served as the concurring partner for the 1988 and 1989 audits of Kahler Corporation, a publicly held company which owns and manages hotels. *Id.* at A-2, A-10. As concurring partner, petitioner's responsibility was to provide a second-level review of Kahler's audits and thus to afford further assurance—that is, assurance in addition to that given by the engagement partner, who led the audit team—that Kahler's financial statements conformed with generally accepted accounting principles (GAAP) and that the audits were conducted in accordance with generally accepted auditing standards (GAAS). *Id.* at A-2 to A-3. The responsibility was an important one. Under guidelines issued by the SEC Practice Section (SECPS) of the American Institute of Certified Public Accountants (AICPA), an audit report on a publicly held company may not be released unless a concurring partner reviews the report and agrees that the audit was conducted in accordance with GAAS and that the company's financial statements conform to GAAP. *Id.* at A-10 to A-11 n.1. Because Touche, like all the major accounting firms, is a member of the AICPA, Kahler's audit reports could not have been released without petitioner's concurrence.

Petitioner concurred in Touche's unqualified audit reports on Kahler's financial statements for both 1988 and 1989. Pet. App. A-3. Both financial statements accounted for, among other things, a Kahler property

known as the University Park Hotel (Hotel). *Id.* at A-2. The Hotel lost money both years, and for each of those years Kahler accounted for the Hotel as an asset held for sale. *Ibid.* That treatment of the Hotel allowed Kahler to factor the Hotel's losses into the Hotel's carrying value rather than deducting those losses from Kahler's current income. *Ibid.* As a result, Kahler posted a net gain instead of a $1.108 million net loss for fiscal year 1988, and a net loss of $1.842 million instead of a $2.808 million net loss for fiscal year 1989. *Id.* at A-14.

2. The Securities and Exchange Commission (SEC or Commission) subsequently conducted an investigation into Kahler's accounting treatment and financial statement presentation of the Hotel in 1988 and 1989, and into Touche's audits of those financial statements. Based on petitioner's performance in connection with the audits, an administrative law judge (ALJ) found that he had recklessly engaged in improper professional conduct in violation of SEC Rule 2(e)(1), 17 C.F.R. 201.102(e)(1). Pet. App. A-2, A-11. The ALJ suspended petitioner from practice before the Commission for a period of eighteen months. *Ibid.*

3. Petitioner appealed the ALJ's decision to the Commission, arguing, among other things, that both Kahler's accounting treatment of the Hotel and petitioner's conduct were proper, that the Commission had no authority to discipline petitioner, and that, even if it did, it failed to provide him with adequate notice of the standards by which his conduct would be judged. Pet. App. A-15, A-23, A-33, A-34. The Commission rejected those arguments. Reviewing the ALJ's decision *de novo*, the Commission agreed with the ALJ that petitioner had recklessly engaged in improper professional conduct. *Id.* at A-31 to A-33. The Commission did,

however, reduce petitioner's suspension from eighteen to nine months. *Id.* at A-41 to A-42, A-61.

The Commission found that Kahler's treatment of the Hotel as an asset held for sale was improper under GAAP. Pet. App. A-15 to A-19. GAAP, the Commission observed, permits a company to account for a property as an asset held for sale and to defer its losses only if the company satisfies a series of requirements. *Id.* at A-15. Those requirements include, among other things, that the company have a formal plan to sell its entire interest in the property, and that it determine that the sale of the property will result in a net gain after considering any unreported losses. *Ibid.* The Commission found that Kahler failed to satisfy these requirements because (1) Kahler did not pursue an outright sale of the Hotel, but instead repeatedly sought investors only to share ownership of the Hotel with Kahler (*id.* at A-16 to A-17); (2) Kahler did not have a formal plan to dispose of the Hotel (*id.* at A-17 to A-18); (3) Kahler's management had no basis to conclude that the Hotel's selling price would make up for its operating losses because the management "failed to assess adequately the Hotel's net realizable value and failed to estimate the Hotel's operating losses to be incurred prior to sale" (*id.* at A-19); and (4) although Kahler's Board of Directors first authorized sale of an interest in the Hotel in mid-April 1988, Kahler treated the property as an asset held for sale from the beginning of that year. *Ibid.* Accordingly, the Commission concluded, Kahler's accounting treatment of the Hotel was improper under GAAP. *Id.* at A-15 to A-19.

The Commission also concluded that petitioner engaged in improper professional conduct when he concurred in Touche's audit report. Pet. App. A-20 to A-33. The Commission relied on the professional

standards described in the AICPA's Statements on Auditing Standards, expert testimony offered by both sides, the statement in the AICPA manual that broadly defines the concurring partner's role, and prior Commission decisions that had discussed the obligations of concurring partners. *Id.* at A-20 to A-23, A-34 to A-38. The Commission's analysis, it noted, was "shaped[] in part[] by [its] recognition of * * * [petitioner's] extensive professional experience and familiarity with Kahler's operations; [his] knowledge of the contents of the work papers * * *; and [his] knowledge that the accounting treatment utilized was material to the financial statements." *Id.* at A-23 to A-24. For several reasons, the Commission found that petitioner's conduct as concurring partner failed to comply with the standards set forth in these sources. *Id.* at A-24 to A-31.

To begin, petitioner concurred in the audit reports despite the absence of a formal plan to sell Kahler's entire interest in the property. Pet. App. A-24 to A-27. Indeed, the Commission pointed out, petitioner knew that the audit record contained documentary evidence showing that Kahler did not intend to sell the Hotel outright, but instead was attempting to dispose of a partial interest. *Id.* at A-24. When petitioner suggested that Gregory J. Melsen, the engagement partner for the Kahler audits, ascertain Kahler's actual intentions, Melsen obtained only unsubstantiated assurances from company management and the audit committee of the Board of Directors. *Id.* at A-25. Neither management's nor the audit committee's assurances negated or explained the contrary evidence, and neither was accompanied by any supporting documentation that might have done so. *Id.* at A-26. Even so, petitioner accepted Melsen's assurances that

Kahler had complied with the formal plan requirement and was in fact committed to selling its entire interest in the Hotel. *Id.* at A-26 to A-27.

Petitioner also concurred in the audit reports even though the audit record did not contain sufficient competent evidence to support a reasonable expectation of a net gain on sale of the Hotel. Pet. App. A-28 to A-30. The audit record for 1988 contained no reliable evidence of the Hotel's worth, while the record for 1989 contained a valuation by Touche's own Valuation Office of $11.4 million, far below the $16.75 million book value, and much less than was required to produce a net gain on sale of the Hotel. *Ibid.* In response, the audit team made "correct[ions]" to the numbers used in the Touche valuation, substituting Kahler's higher projections of future cash flow for the projections, based on historical results, that the Valuation Office had used. *Id.* at A-29 to A-30. These changes, the Commission pointed out, had the effect of increasing the purported value of the property, apparently "in an effort to demonstrate compliance with the requirements" for deferring the operating losses of the Hotel. *Id.* at A-29. Petitioner, again accepting Melsen's assurances, concurred in the reports without ever receiving explanations for the changes and despite his knowledge of the relevant facts, including "various documentation that * * * strongly cautioned against reliance on Kahler-generated projections." *Id.* at A-30. In addition, petitioner inexplicably agreed with treating the Hotel as an asset held for sale for all of 1988. *Id.* at A-30 to A-31.

The Commission ruled that in light of the total audit environment, including the keen significance to the financial statements of the Hotel-related loss deferrals and the heightened risk of material misstatement caused by Kahler's history of aggressive accounting,

petitioner's "deviations from the duties imposed by GAAP and GAAS constitute improper professional conduct." Pet. App. A-32. Petitioner, the Commission found, "acted recklessly in indicating, with respect to both audits, that he had reviewed the financial statements and concluded that they satisfied the standards of the profession." *Id.* at A-31 to A-32 (footnote omitted). The Commission defined recklessness as "not merely a form of ordinary negligence," but "an 'extreme departure from the standards of ordinary care, which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.'" *Id.* at A-32 n.40. The Commission emphasized that a concurring partner "provides important additional assurance" that GAAS and GAAP have been complied with, and that his or her role "is to provide substantially more than 'window dressing.'" *Id.* at A-32 to A-33. It further observed that petitioner's "substantial departures from his professional duties establishes that this Commission cannot rely upon [petitioner] to perform diligently and with reasonable competence his audit responsibilities." *Id.* at A-33.

The Commission also rejected petitioner's challenges to its authority to enforce Rule 2(e) (17 C.F.R. 201.102(e)) against him in this context. The Commission noted that the courts of appeals that have addressed the validity of Rule 2(e) have upheld the rule as "'reasonably related' to the purposes of the securities laws." Pet. App. A-34. As to petitioner's argument that he had no notice of the governing principles, the Commission pointed out that GAAS and GAAP are standards to which all accountants must adhere and which are "within [petitioner's] ready understanding." *Id.* at A-35. The Commission also explained that its

"opinions and orders in a range of settled matters" both have "provided guidance to the accounting profession as to the standards expected of concurring partners" (*ibid.*) and have "explored the nature of due care and professional skepticism * * * as these concepts relate to accountants generally." *Id.* at A-36. Thus, the Commission concluded, petitioner was not "without guidance as to appropriate professional standards." *Id.* at A-34.

4. Petitioner sought review of the Commission's decision in the court of appeals. He argued principally that substantial evidence did not support the Commission's findings of recklessness and of improper professional conduct, and that the professional standards governing concurring partners had not provided adequate notice of the performance expected of him. Pet. App. A-2, A-6.

The court of appeals affirmed the Commission's order in all respects. Pet. App. A-1 to A-7. The court found that substantial evidence supported the Commission's finding that petitioner recklessly failed to carry out his professional responsibilities. *Id.* at A-2 to A-6. It could reasonably be concluded, the court stated, that petitioner's conduct in approving the audits "based on Melsen's unprobed, untested representations" and in sanctioning the backdating of the asset for sale treatment to the start of 1988 amounted to an "egregious refusal to see the obvious, or to investigate the doubtful." *Id.* at A-5 (citing *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1426 (9th Cir. 1994), cert. denied, 516 U.S. 868 and 909 (1995)).

The court of appeals also rejected petitioner's assertion that he was denied due process because he did not have adequate notice of the standards of professional conduct for concurring partners that the Commission

applied to his case. Pet. App. A-6 to A-7. The court of appeals explained that "[t]he SEC did not invent new standards in this case." *Id.* at A-6. Rather, "the Commission evaluated [petitioner's] conduct in light of the well-established norms of the accounting profession," namely GAAP and GAAS. *Ibid.* The court of appeals observed that, while GAAP and GAAS do not require concurring partner review, such review is required by the major accounting firms for audits of publicly held companies. *Ibid.* The court of appeals explained that petitioner, "[h]aving taken on the concurring review task, * * * also shouldered the duty to perform that task professionally." *Ibid.*

As to the duties of a concurring partner, the court of appeals found that "[a]lthough a concurring reviewer is not expected to do the audit all over again, [petitioner's] own expert witness agreed that a concurring partner must evaluate the financial statements and audit in light of GAAP and GAAS." Pet. App. A-6. "To do so competently," the court of appeals stated, "the concurring partner must observe the commonsense principles the SEC applied here." *Id.* at A-6 to A-7. The court of appeals pointed out that "the SEC has consistently evaluated the professional conduct of concurring partners under GAAP and GAAS" and, by 1988, had issued several opinions and orders that specifically addressed the duties of a concurring partner or one performing an equivalent role under a different name. *Id.* at A-7. Thus, the court of appeals found, "[petitioner] had a reasonable opportunity to know what the SEC expected of him." *Ibid.*

ARGUMENT

Petitioner argues that he was suspended without due process because he did not have adequate notice of the

professional standards that the Commission applied (Pet. 13-22), and that the Commission exceeded its statutory authority by impermissibly promulgating new accounting standards for concurring partners under the guise of regulating improper professional conduct by those who appear before it. Pet. 22-29. The premise of these arguments fails, however, because, as the Commission explicitly found, petitioner recklessly failed to comply with the *established* professional standards for concurring partners. Pet. App. A-31 to A-33. In essence, then, petitioner is challenging the court of appeals' conclusion that the Commission's findings are supported by substantial evidence. The court of appeals' decision is correct and does not conflict with any decision of this Court or of any other court of appeals. Accordingly, further review is not warranted.

1. Petitioner does not deny that the Kahler accounting was improper for both years.[1] Instead, he claims that he may not be disciplined because the professional standards applied by the Commission were newly announced in this case, and that the Commission "imposed its sanction even though" petitioner's conduct complied with the "existing standards of the industry." Pet. i.

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[1] It is well-established, and petitioner does not dispute, that the Commission has the authority to promulgate Rule 2(e) as a means of protecting its processes from the harm that can be caused by professionals who deviate from the applicable professional standards. See *Touche Ross & Co.* v. *SEC*, 609 F.2d 570, 572-573 (2d Cir. 1979) (Rule 2(e) is an attempt by the Commission to protect the integrity of its processes, and is therefore an appropriate exercise of the Commission's rulemaking authority); *Sheldon* v. *SEC*, 45 F.3d 1515, 1518 (11th Cir. 1995) (same); *Checkosky* v. *SEC*, 23 F.3d 452, 455 (1994) (opinion of Silberman, J.) (same), following remand, 139 F.3d 221 (D.C. Cir. 1998); *Davy* v. *SEC*, 792 F.2d 1418, 1421-1422 (9th Cir. 1986) (same).

Petitioner even goes so far as to assert that his compliance with the existing standards is undisputed.[2]

Petitioner's arguments have no merit. In the words of the court of appeals, the Commission "did not invent new standards in this case," but instead evaluated petitioner's conduct "in light of the well-established norms of the accounting profession, collectively referred to as GAAP and GAAS." Pet. App. A-6. Petitioner was suspended because, as the court of appeals correctly pointed out, he did not observe the settled, "commonsense principles" that were to be used by the Commission in evaluating his performance. *Ibid.* Thus, the petition raises only the narrow issue of whether the Commission's application of established professional standards to petitioner's specific conduct should be upheld.

Petitioner mistakenly suggests that this case turns on his failure to take sufficient steps to discover the problems in the audits. Pet. 23-24. To the contrary, substantial evidence shows that petitioner knew of the problems in the accounting and in the audits. His improper professional conduct took place when he concurred in the audit reports despite the fact that these problems had not been adequately explained or resolved. See Pet. App. A-23 to A-31.

To ascertain the scope of petitioner's duties in applying GAAP and GAAS, the Commission looked

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[2] For instance, petitioner states that there were existing guidelines for a concurring partner to follow in 1989 and 1990, "and no one disputes that [petitioner] met those guidelines." Pet. 12; see also Pet. 13 (imposition of a sanction for "conduct that complied with industry * * * standards" calls for granting of review by this Court), 15 ("There is no question in this case that [petitioner] complied with the only guidance available to him on the role of the concurring partner.").

first to the AICPA SECPS Manual, which states that member firms must adopt the following "minimum" policies and procedures for concurring partner review:

> Reading the financial statements and the firm's report thereon and making an objective review of significant accounting, auditing, or reporting considerations. This review should be performed prior to the release of the report and should include discussions with the partner in charge of the engagement and review of selected working papers.

Pet. App. A-21.

These requirements were fleshed out by accounting experts called by both sides to testify concerning the professional standards with which all competent accountants should be familiar. Both the Commission and the court of appeals referred to the testimony of petitioner's own expert, Edward J. Kerans, on the concurring partner's responsibilities. Pet. App. A-6, A-24. Kerans compared the concurring partner to the last inspector at a car plant who looks at the final product before it goes out the door. When he was asked what the concurring partner would do if he kicks the tires and the car sways to the left abruptly, Kerans answered:

> He needs to investigate that. He needs to go back and see how that engagement management team dealt with that. So he would have to go back on the line and take it to the particular unit section and say that I've seen this issue, what is it that we've done about this. And so it's going to be pursued and investigated. * * * He has to become satisfied as to the resolution of that question.

Gov't C.A. Supp. App. 213.

When asked what steps he would take as concurring partner if he was not satisfied with the answers he received, Kerans replied that he would ask

> [a]dditional questions. * * * I'm going to have to become satisfied. * * * Before I basically clear the report, I will have to become satisfied. * * * The engagement partner has a responsibility to do that. In other words, he has to respond to my questions. If he has satisfied me in responding to those questions and I have no additional questions, I'll clear it. If he has not satisfied me and refuses to pursue it further, we're now in the area of a disagreement and Touche as well as Coopers & Lybrand has a policy for handling disagreements.

Gov't C.A. Supp. App. 214-215. One of the steps Kerans said he would take when acting as a concurring partner if he was not satisfied was to ask the engagement partner to provide him with further evidence. *Id.* at 215. Kerans also stated that the concurring partner has substantial responsibility, because he has to use his knowledge in the area in order to raise questions and then come to a conclusion whether or not the audit and financial statements meet GAAS and GAAP, and because a report on a public company will not be issued without the concurring partner's signature. *Id.* at 218-219.

The three experts called by the Commission gave testimony substantially similar to that of Kerans with respect to the professional standards applicable to a concurring partner.[3] Gov't C.A. Supp. App. 19, 78-80,

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[3] Petitioner's expert and the experts called by the Commission did not disagree about the duties of a concurring partner. They disagreed only about whether petitioner had adequately performed those duties.

148-154. Thus, petitioner is incorrect in asserting that neither petitioner "nor anyone else in the industry would have expected that the role of the concurring partner meant what the Commission now says it means."[4] Pet. 12.

Finally, as the court of appeals noted (Pet. App. A-7), the Commission had issued several opinions and orders in settled cases prior to 1988 that addressed and explained the responsibility of accountants acting as concurring partners to provide additional assurances of compliance with GAAS and GAAP. Thus, the instant case is not, as petitioner asserts (Pet. 3), the Commission's first decision involving concurring partners. Nor, for that matter, does it represent an attempt by the Commission to promulgate new accounting and auditing standards for concurring partners under the pretense of regulating their professional conduct as accountants.

In sum, petitioner is incorrect in claiming that the Commission suspended him even though he had "complied with [existing] standards." Pet. 28. The Commission based the suspension on its finding that petitioner had gravely departed from those standards.

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[4] This case is therefore readily distinguishable from *In re Carter*, 47 S.E.C. 471 (1981). *Carter* involved the application of Rule 2(e) to attorneys and turned on the Commission's finding that "[t]he ethical and professional responsibilities of lawyers who become aware that their client is engaging in violations of the securities laws" had not been sufficiently established to justify holding "all practicing lawyers * * * to an awareness of generally recognized norms." 47 S.E.C. at 508. Here, in contrast, the relevant professional norms were adequately delineated.

As the court of appeals correctly held, that finding was amply supported by the record in this case.[5]

2. The decision in this case does not conflict with any decision of this Court or of any court of appeals. Petitioner discusses two cases that he claims support his contentions. See Pet. 18-22, discussing *Checkosky* v. *SEC*, 23 F.3d 452 (1994), following remand, 139 F.3d 221 (D.C. Cir. 1998); and *Upton* v. *SEC*, 75 F.3d 92 (2d Cir. 1996). Each of those decisions is irrelevant to petitioner's claims.

In *Checkosky*, the court of appeals ultimately dismissed a Commission disciplinary proceeding against two accountants because it found that, despite the court's prior remand of the case to the Commission for further explanation of the basis for its decision, the Commission failed adequately to explain whether the decision rested on a finding that the accountants had acted recklessly. See 139 F.3d at 227; 23 F.3d at 465-466. In this case, however, the Commission explicitly found that petitioner had acted recklessly, it defended its decision on that basis in the court of appeals, and the court of appeals affirmed the decision on that ground. Pet. App. A-5 to A-6. Hence, *Checkosky* is inapposite.

Petitioner's reliance on *Upton* is similarly misplaced. In *Upton*, the court of appeals affirmed the Commission's construction of one of its rules but held that a securities firm employee who was the respondent in

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[5] Petitioner also says that it is undisputed that he complied with Touche's requirements for concurring partners. See, *e.g.*, Pet. 13. That assertion, however, is irrelevant to this case, because the Commission was not applying Touche's firm policies and did not have occasion to determine whether petitioner complied with them. The lack of dispute about petitioner's claim that he complied with firm policies, then, does not mean that the Commission agrees with his assertion.

that case could not be disciplined under the rule because the employee had complied with the rule's "literal" requirements and did not have notice that the Commission viewed his conduct to be a violation despite such "literal" compliance. See 75 F.3d at 96-98. Petitioner did not comply with the literal terms of a governing rule. Moreover, for the reasons we have stated (see pp. 10-15, *supra*), petitioner had a "reasonable opportunity to know" (*Upton*, 75 F.3d at 98 (quotation marks omitted)) that the Commission could find that his reckless deviations from the applicable professional standards constituted improper professional conduct.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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